Managing Concentrated Positions

Many investors accumulate large amounts of wealth by investing in a single company, whether that be from executive compensation, inheritance, or just smart stock picking. What can start out as a diversified portfolio may morph into one stock taking up a large percentage of the portfolio. We see this frequently in the Pacific Northwest, where tech companies have seen massive growth and many employees of these companies have benefited greatly.

There is a point where a single company may take up too large of a percentage in the portfolio (typically anything over a 10% position) resulting in investors taking on too much company-specific risk. Investors often underestimate the risks of holding such concentrated positions, they may have a high level of confidence about the stock's prospects or assume the future will be the same as the past, while others want to avoid paying taxes at all costs. While some taxes are inevitable, there are ways to manage taxes efficiently while diversifying the portfolio.
By ignoring the risks of over-concentration, investors are exposing themselves to portfolio declines that can destroy wealth and derail long-term financial goals.

There are many factors that can impact your strategy for handling concentrated positions, which is why it all comes back to the financial plan and focusing on the long-term objectives. Some may need to liquidate the position to shift to income-generating securities, and others may not need that portion of their portfolio for cash flow and wish to pass along to heirs. A few key questions to consider include:

- Do you need liquidity?
- What is your willingness and ability to take risk?
- How much tax are you willing and able to pay?
- What is your outlook on the stock and what are analysts' outlook?

There are many potential solutions to de-risk the portfolio and minimize taxes, all which have their pros and cons. For many investors it ends up being a blend of solutions to meet the end goal. We recommend reviewing with your wealth consultant and tax professional to determine which is right for you. If you are interested in learning how Evergreen can help, click here to take our client compatibility survey.

Selling Shares
The simplest solution, and the least tax advantageous in the short-term, is to sell all or part of the position. Reviewing in accordance with your financial plan can help you determine how many shares to liquidate as well as a liquidation schedule. Sticking with a plan to sell shares over time by assessing your own willingness and ability to pay tax can help reduce the tax impact as well as the risk of selling out at the wrong time.

Hedging Strategies
Option strategies are often used by those who are restricted from selling stock or do not want to realize taxes. Equity collars are used to limit the downside risk on a stock. This strategy sells call options, which gives the owner the right to purchase the stock at a determined price, and buys put options, which gives the holder the right to sell the stock at a specific price. These options can be complex and have significant tax implications, so we recommend working with a tax advisor.

Exchange funds

Exchange funds allow you to swap a concentrated position for a diversified basket of stocks. These are private placement funds that offer instant diversification without triggering a taxable event, and typically require investors to stay in the fund for a period, often 7 years. These funds offer a way to diversify against single company risk, but do not eliminate capital gains as the original cost basis stays the same. Fees are often higher for these products than for typical passive investments, and minimums can range from $500,000 to $1,000,000. While not a fit for everyone, this can be a way to mitigate the company-specific risk.

Qualified Opportunity Zone

Qualified Opportunity Zones (QOZs) are another way to defer the gain on a sale, but not eliminate entirely. The Tax Cuts and Jobs Act of 2017 created QOZs, which are economically distressed communities where new investments may be eligible for preferential tax treatment. [1] Qualified Opportunity Funds are investment vehicles to gain access to these benefits. The gain on the sale is deferred until 2026, and any gains on the amount invested in the fund are tax-free if held for 10 years. These funds have high minimums, fees, limited liquidity, and returns can vary, but may be an option for some looking to defer large capital gains.

Gifts to Loved Ones

If the stock in question is not needed to fund cash flow or retirement goals and you wish to make gifts during your lifetime, gifting appreciated stock can be a good option. By gifting during lifetime, you can remove the assets from your estate and shift the tax obligation to those who may be in a lower tax bracket. In 2022, you can give $16,000 per person ($32,000 per couple) to each beneficiary.[2] Gifts can also be made to a trust, so access to the funds can be restricted. The receiver of the gift will inherit the original cost basis, so it is important to discuss tax ramifications with the beneficiaries and plan accordingly.

Charitable Giving

For those with philanthropic goals, gifting appreciated stock to charity is another way to reduce stock exposure. Charitable Remainder Trusts (CRTs) allow an immediate tax deduction while providing income to the grantor. The portfolio can be diversified, and at the termination of trust the assets pass to a charity of choice. Donor Advised Funds (DAFs) allow for gifting over time. You can bunch contributions for multiple years into one tax year, maximizing the allowed itemized deductions to receive an immediate tax benefit, and then give over time to the charities of choice. For those that are philanthropic these can be helpful vehicles.

When Not to Sell

It is not always advantageous to diversify a concentrated position. If the goal is to bequeath these assets at your passing, you should hold the stock so the beneficiaries receive a full step-up in cost basis, and they can diversify without realizing capital gains. It is important to review within the context of your own financial and estate plan to determine the optimal strategy for you.

[1]https://www.irs.gov/credits-deductions/opportunity-zones-frequently-asked-questions
[2]https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax

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